



June 24, 1996

TO: Philip Lader

Administrator

THROUGH: James F. Hoobler

Inspector General

FROM: Tim Cross

Assistant Inspector General

For Inspection and Evaluation

SUBJECT: Inspection of SBA's 7(a) General Business Loan Program Loss Rate

I am pleased to submit the inspection report you requested on SBA's 7(a) general business loan program loss rate. It focuses on the methodology used to compute loss rates for the 7(a) general business loan program and on the use of these rates by SBA officials. Office of the Chief Financial Officer (OCFO) and Office of Financial Assistance (OFA) officials concurred with the inspection's conclusions, but OFA disagreed with a key recommendation.

While there are minor differences in the way the SBA and the banking industry compute the commercial, or one-year, loss rate, we found that the methodology used by SBA is fundamentally valid. It is consistent with the methods used by Federal banking regulators.

We also found, however, that SBA's commercial loss rate is not comparable with banking industry loss rates due to significant differences in their respective loan

objectives and portfolios. SBA and banking objectives vary substantially because the latter are for-profit businesses charged with providing dividends to their shareholders. SBA's loan guarantee program is designed to promote small business formation and growth. More importantly, SBA's loan portfolio differs significantly from that of the banking industry in several important aspects: SBA's portfolio includes only small businesses, whereas the industry rate reflects losses on loans to businesses of all sizes; SBA's loans are concentrated in only two industries—retail trade and services—while the private lender loans cut across all industries; and SBA's portfolio includes real estate loans, which are excluded from the industry loss rates. Differing charge-off policies also affect the timing of charge-offs and, therefore, the loss rates.

The commercial loss rate is also misleading as an indicator of current 7(a) loan program performance because of the rapidly expanding portfolio and the three-to-four year lag between loan disbursements and charge-offs. SBA's portfolio has increased by 118 percent in the past ten years, while the banking industry portfolio has grown only five percent, and most losses on unseasoned loans are unlikely to have occurred. It should also be noted that SBA program officials no longer used the commercial loss rate for internal management purposes; they focus instead on cohort performance and other indicators such as purchase, currency, and subsidy rates, which appear to be more useful measures.

For these reasons, we recommend that SBA discontinue the use of the commercial loss rate for the 7(a) loan program. While OFA officials acknowledge the validity of our arguments, they believe that there are practical reasons for continuing the use of the commercial loss rate. They assert that the rate is useful for comparisons with the commercial lending industry because the methodologies are similar and the rate is easily understood—whereas the subsidy rate and its derivatives are not. OFA officials believe that the commercial loss rate can still be used if caveats are provided to indicate that SBA's loan portfolio, unlike that of commercial lenders, includes only small business loans, and that there are differences in charge-off policies. In our view, however, simply adding these caveats is not sufficient to justify SBA's continued use of the commercial loss rate for comparing its loan losses with those of the private industry.

OCFO officials also agree with the inspection's conclusions on the use of the 7(a) commercial loss rate, and they intend to circulate a decision document to SBA's top management to seek concurrence. They indicate that our conclusions also apply to the Disaster, 504 Development Company, and SBIC programs. We did not address the use of commercial loss rate by those programs, and therefore cannot include those programs in our recommendation. Moreover, we are not aware that SBA makes comparisons between those programs and the private banking industry as a whole.

Because loss and default rates are sometimes used interchangeably, we included a discussion of default rates in this inspection. We found that loss and default rate data are not always properly identified, and may inadvertently misrepresent 7(a) program performance. We recommend that the OCFO and OFA ensure that information on loss and default rates is more clearly defined and labeled.

Each year the OCFO publishes an Annual Loss Study which includes not only the commercial loss rate, but also "actual" (cumulative) and "ultimate" (cumulative plus projected) loss rates for each of SBA's loan programs. Credit reform, however, has significantly changed the way loan information is tracked, necessitating two different methods of presenting loan information in the Annual Loss Study—one for pre- and one for post-credit reform data. We recommend that the OCFO determine whether revisions can be made in the format of the Annual Loss Study to clarify loan loss data.

We appreciate the excellent cooperation we received from both the OCFO and the OFA. If you have any questions, we would be happy to discuss them with you at your convenience.

Attachment

The 7(a)

General Business Loan Program

Loss Rate

June 1996

Inspection Report

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ABBREVIATIONS

ABA	American Bankers Association
C&I	Commercial and Industrial Loans
Fed	Federal Reserve Bank
FDIC	Federal Deposit Insurance Corporation

GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
OCFO	Office of the Chief Financial Officer
OFA	Office of Financial Assistance
OIG	Office of the Inspector General
SBA	Small Business Administration
SIC	Standard Industrial Classification
SOP	Standard Operating Procedure

EXECUTIVE SUMMARY

This inspection was initiated at the request of the Administrator of the Small Business Administration (SBA). It focuses on the methodology used to compute loss rates for the 7(a) general business loan program and on the use of these rates by SBA officials. Each year the Office of the Chief Financial Officer (OCFO) publishes an Annual Loss Study which includes the "commercial," "actual," and "ultimate" loss rates for each of SBA's loan programs. The commercial, or one-year, loss rate was developed to compare program performance with that of private sector lenders. The actual loss rate is a cumulative rate, while the ultimate loss rate is a projection of future losses. Because loss and default rates are sometimes used interchangeably, we have included a discussion of default rates in this inspection.

We reviewed relevant documents and conducted interviews with officials of SBA's OCFO and Office of Financial Assistance (OFA), the American Bankers Association (ABA), and Federal bank regulatory agencies. To date, there has been no comprehensive effort to verify the accuracy of the field data used to calculate 7(a) loss rates; however, a current Office of Inspector General (OIG) audit of 7(a) loan liquidations will verify the accuracy of charge-offs and recoveries in a random sample of loan files.

The methodology used by SBA to calculate the commercial, or one-year, loss rate is fundamentally valid. While there are slight differences between the SBA and the banking industry regarding the specific elements composing the numerator and denominator, the added components in SBA's calculation have a minimal effect on the loss rate.

SBA's commercial loss rate is not comparable with banking industry loss rates because the loan objectives and portfolios differ significantly. SBA and banking objectives vary substantially because the latter are for-profit businesses charged with providing dividends to their shareholders. SBA's loan guarantee program is designed to promote small business formation and growth. Further, SBA's loan portfolio is significantly different from that of the banking industry. First, SBA's loss rate reflects a small business loan portfolio, while banking industry loss rates include loans to all businesses, large or small. Second, banking industry loans cut across all industries, while SBA's are concentrated in two Standard Industrial Classification (SIC) codes--retail trade and services. Third, the banking industry commercial and industrial (C&I) loss rates exclude real estate loans, while real estate loans are not separated from SBA's loan portfolio. Differing charge-off policies also affect the timing of charge-offs and, therefore, the loss rates.

The usefulness of the commercial loss rate is limited by two factors: (1) a rapidly expanding portfolio and (2) the three-to-four year lag between loan disbursements and charge-offs. SBA's portfolio has increased by 118 percent in the past ten years. During the same period, the banking industry portfolio has increased only five percent. Although the commercial loss rate shows trends in SBA's loan portfolio over time and may indicate improved performance for loans made five to ten years ago, it provides little information about the behavior of loans disbursed during the last three-to-four years. Thus, SBA's rapid portfolio growth can create a misleading picture with regard to loss rates because most losses on unseasoned loans are unlikely to have occurred.

SBA program officials no longer use the commercial loss rate as a management tool. They indicated that they now focus on cohort performance and other indicators such as purchase, currency, and subsidy rates. Since the FY 1992 implementation of credit reform, the OCFO has tracked all loans on a yearly cohort basis. This information provides the best measure of loan performance because cohorts at the same stages of the maturation process can be compared.

For these reasons, **we recommend that SBA discontinue the use of the commercial loss rate for the 7(a) general business loan program.**

Loss and default rate data are not always properly identified, and may inadvertently misrepresent 7(a) loan program performance. We found that the presentation of SBA's loss rates in the Annual Loss Studies and in some submissions to Congress needs additional clarification. Moreover, because there is no standard definition for the term "default" either in SBA or in the banking industry, there can be confusion over what SBA default rates represent--a loan payment delinquency rate or a purchase rate. According to program officials, it is not unusual for people to confuse the loss and default rates. **We recommend that the OCFO and OFA ensure that information on loss and default rates is more clearly defined and labeled.**

While the actual and ultimate loss rates are used primarily for internal purposes, the Annual Loss Studies in which they are published contain useful program

performance information. Credit reform, however, has significantly changed the way loan information is tracked. This has necessitated two different methods of presenting loan information in the Annual Loss Study--one for pre- and one for post-credit reform data. **We recommend that the OCFO determine, in consultation with appropriate program officials, whether revisions can be made in the format of the Annual Loss Study to clarify loan loss data.**

SBA Comments

OCFO and OFA officials agreed with the inspection's conclusions, but OFA did not concur with the recommendation to discontinue use of the commercial loss rate for the 7(a) general business loan program. While acknowledging the validity of the report's arguments against its use, OFA officials believe that there are practical reasons for continued use. They assert that the rate is (1) useful for comparisons with the commercial lending industry because of the similar methodology used and (2) easily understood, whereas the subsidy rate and its derivatives are not.

OFA officials believe that the commercial loss rate can still be used with the following caveats: (1) SBA's loan portfolio differs from that of commercial lending institutions because the latter make other than small business loans and (2) SBA does not charge off an account until all worthwhile recovery has been obtained, while banks quickly charge off non-performing loans. OCFO officials also agree with the inspection's conclusions regarding the use by SBA of the commercial loss rate, and they intend to circulate a decision document to SBA's top management to seek concurrence. They indicate that our conclusions also apply to the Disaster, 504 Development Company, and SBIC programs. We did not address the use of the commercial loss rate by those programs, and therefore cannot include those programs in our recommendation. Moreover, we are not aware that SBA makes comparisons between those programs and the private banking industry as a whole.

We strongly disagree with the continued use of the commercial loss rate. It was created specifically to make comparisons with the private banking industry even though it lacks comparability because of differing loan objectives, portfolio composition, and charge-off policies. Even more important, the commercial loss rate is misleading as an indicator of current 7(a) general business loan program performance because of the rapidly expanding portfolio and the three-to-four year lag between loan disbursements and charge-offs. Its limited usefulness is further demonstrated by its lack of use by program officials as a management tool. Simply adding the caveats proposed by OFA is not sufficient, in our opinion, to make SBA's 7(a) commercial loss rate suitable for comparison with private industry.

In response to our other two recommendations, the OCFO plans to condense the Annual Loss Rate Study and present the information in a clearer and more consistent manner.

BACKGROUND

This OIG inspection was initiated at the request of the Administrator of the SBA to validate the methodology used to compute loss rates for the 7(a) business loan program. SBA's OCFO, which is responsible for calculating the loss rates for the 7(a) program, publishes an Annual Loss Study which includes the "commercial," "actual," and "ultimate" loss rates for each of SBA's loan programs.

Prior to 1989, SBA calculated only the actual and ultimate loss rates for loan programs. The actual loss rate represents total cumulative losses, while the ultimate loss rate is an estimate of total future losses on loans presently outstanding. Neither rate has an equivalent in the private banking sector. According to SBA officials, the actual loss rate does not provide a fair comparison with the yearly loss rate used by the banking industry because it is calculated on a cumulative basis. Therefore, the Comptroller's Office developed a commercial, or one-year, loss rate for each loan program to permit SBA program officials to compare program performance with that of private sector lenders. Although the commercial loss rate was also used in the past to evaluate 7(a) loan trends, SBA program management currently uses better measures to assess loan portfolio trends, including subsidy, purchase, and delinquency rates.

Early in the inspection, the OIG team found that there is confusion surrounding the use of 7(a) loss and default rates, which are sometimes used interchangeably. Moreover, neither SBA nor the banking industry has a standard definition of "default." We therefore included in this inspection a discussion of the default rate.

OBJECTIVES, SCOPE, AND METHODOLOGY

This inspection focuses on the methodology used by SBA's OCFO to calculate 7(a) general business loan program loss rates and on the use of these rates by SBA program officials. The financial data employed to calculate both loss and default rates is entered into the loan accounting system by SBA field offices and loan centers. It was not, however, within the scope of this review to audit those offices to determine the accuracy of the data being input. It should be noted that the OIG's Auditing Division is currently conducting an audit of 7(a) liquidations which will test the accuracy of loan charge-offs and recoveries in a statistical sample of loans.

To conduct this inspection, we interviewed OCFO and OFA officials and reviewed the OCFO's Annual Loss Studies; the relevant standard operating procedures (SOP); the annual financial statement audits performed by Cotton & Company; and reports by the OIG, the General Accounting Office (GAO) and others that address the 7(a) business loan program. To determine the methods used in the banking industry to calculate loss rates, we interviewed representatives of the ABA and the three major Federal bank

regulatory agencies--the Office of the Comptroller of the Currency (OCC), the Federal Reserve (Fed), and the Federal Deposit Insurance Corporation (FDIC). We conducted our work between October 1995 and March 1996 in accordance with the Quality Standards for Inspections issued in March 1993 by the President's Council on Integrity and Efficiency.

LOSS RATES

Discussion

Commercial Loss Rate. SBA computes and uses a "commercial loss rate" to compare the performance of 7(a) loans with those of private sector lenders. The commercial loss rate is a one-year measurement which is calculated by dividing net charge-offs for the year by the average dollar value of loans outstanding.

Following the purchase of a defaulted guaranty loan from a lender, SBA charges off the portion of the loan that is determined to be uncollectible or of such little value that its continuance as a bankable asset is unwarranted. **In determining gross charge-offs, SBA includes (1) the amount charged off less any reversals of previously charged-off items, (2) recoverable expenses, and (3) losses that occur on judgments.**

Conclusion 1: The methodology used by SBA to calculate the commercial, or one-year, loss rate is fundamentally valid.

Validity of the Methodology. We found the methodology SBA uses to calculate its commercial loss rate to be consistent with that used by Federal regulators in reporting banking industry loss rates. All FDIC insured banks are required to complete quarterly reports on their financial status. From these reports, the FDIC calculates industry loss rates by dividing net charge-offs by the average outstanding loan portfolio balance. There are, however, slight differences between the SBA and the banking industry with regard to the specific elements composing the numerator and denominator. For example, banks do not add expenses to the loan balance, while SBA adds recoverable costs; SBA's commercial loss rate denominator includes judgments and acquired collateral that the banking industry excludes; and SBA averages the ending outstanding loan portfolio for the current and prior fiscal years, while the FDIC uses several different methods to calculate the outstanding loan balance. The added components in SBA's calculation, however, are minor and have a minimal effect on the loss rate. Overall, SBA uses methodology similar to that of the banking industry, and we believe it to be fundamentally sound.

Conclusion 2: SBA's commercial loss rate is not comparable with banking industry

loss rates because the loan objectives and portfolios differ significantly.

Comparability with the Banking Industry. SBA and bank objectives vary substantially. Banks are for-profit businesses charged with providing dividends to their shareholders. SBA is a "public-private partnership that uses tax payer dollars to leverage private capital that would not otherwise be made available to the small business sector." More importantly, while the method used by SBA to calculate a one-year loss rate is comparable with that used by the banking industry, the *objects* of comparison, i.e., the loan portfolios, are not. SBA uses commercial and industrial (C&I) loans in making comparisons. Even when only C&I loans are taken into account, SBA's loan portfolio is significantly different from that of the banking industry. First, the industry loss rates include loans to both large and small business. According to SBA, small business loans make up only 39 percent of all C&I loans. Second, banking industry loans cut across all industries, while SBA's portfolio is concentrated in only a few areas. SBA reports that 63 percent of its outstanding loans at the end of FY 1995 had been awarded to businesses in two SIC Code categories--retail trade and services. Third, whereas SBA includes real estate loans in its small business loan portfolio, banks track real estate loans separately.

In addition, SBA and banks have substantially different charge-off policies. Because banks must promptly charge-off the amount of any loan loss that becomes confirmed, they typically charge loans off their books prior to pursuing recoveries. In contrast, SBA's policy is to make all reasonable efforts to collect the entire debt prior to charge-off. This can last several years, delaying the charge-off and its effect on the loss rate. Because of these significant differences, we believe that the 7(a) commercial loss rate should not be used to make comparisons between SBA loan losses and those of the private banks.

Conclusion 3: The usefulness of the commercial loss rate is limited by two factors:

(1) a rapidly expanding portfolio and (2) the three-to-four year lag between loan disbursements and charge-offs.

Limitations of the Commercial Loss Rate. The usefulness of the commercial loss rate is also constrained by two factors: (1) a rapidly expanding portfolio and (2) the three-to-four year lag between loan disbursements and charge-offs. SBA's portfolio has increased by 118 percent in the past ten years, while the banking industry portfolio has grown only five percent. (See Table 1 in Appendix A).

During this period, SBA's average outstanding loan balance (the loss rate denominator) increased significantly, while loan losses (the numerator) gradually declined. As a result,

SBA's commercial loss rate for guaranty loans has fallen from 3.87 percent in 1986 to .81 percent in 1995. (See Table 1.) Although the rate provides a useful view of SBA's loan portfolio over time and may indicate improved program performance for loans made five to ten years ago, it provides little information about the performance of loans disbursed during the last three to four years, i.e., those loans that may not be sufficiently "seasoned" to reflect losses. Thus, SBA's rapid portfolio growth can create a misleading picture with regard to loss rates because most losses on unseasoned loans are unlikely to have occurred.

The banking industry's loss rates on commercial and industrial loans have steadily declined from 1.54 percent to .25 percent between 1986 and 1995 and are slightly lower than SBA's commercial loss rates. (See Table 1.) Regulatory officials attribute the decline primarily to (1) more conservative underwriting by banks, (2) improvements in the national economy, (3) greater diversification in lending portfolios, in terms of loan type and geography, and (4) more sophisticated portfolio management and loan review systems.

Table 1: 7(a) General Business Loan and Banking Industry

Loss Rates

Year	SBA General Business Loans	Banking Industry
1986	3.87%	1.54%
1987	4.05%	1.19%
1988	3.98%	1.09%
1989	3.35%	1.09%
1990	2.81%	1.36%
1991	2.17%	1.80%
1992	1.97%	1.33%
1993	1.60%	0.74%
1994	1.18%	0.27%

1995	0.81%	0.25%
Note: SBA loss rates include guaranty loans only. The SBA loss rate for 1995 uses the same method of calculation used in previous Loss Studies, i.e. only pre-credit reform net charge-offs are used in the numerator.		
Source: SBA, Annual Loss Studies and <u>Loan Profiles - FY 1992</u>; and FDIC Department of Statistics and Research. The <u>Annual Loss Study, FY 1995</u> was still in draft when this table was printed.		

Conclusion 4: SBA program officials no longer use the commercial loss rate as a management tool.

Use as a Management Tool. With the implementation of credit reform in FY 1992, the OCFO began tracking all loans on a yearly cohort basis. Using cohorts to compare loans that are in the same stage of the maturation process provides the best means of monitoring loan performance. Program management indicates that it does not currently use the commercial loss rate as a management tool, either to measure program performance or to identify trends. Because of credit reform, OFA now focuses on cohort performance and other indicators such as purchase, currency, and subsidy rates. Moreover, the subsidy rate calculation takes into account all program costs with the exception of agency administrative costs.

In summary, while the methodology used in computing the commercial loss rate is valid, the public use of the commercial loss rate is no longer advisable because it (1) is not comparable to banking industry loss rates because of different loan objectives and portfolios, (2) is of limited usefulness due to SBA's rapidly expanding loan portfolio and the three-to-four year lag between loan disbursements and charge-offs, and (3) is no longer used by program officials as a management tool.

Recommendation 1: We recommend that SBA discontinue the use of the commercial loss rate for the 7(a) general business loan program.

Conclusion 5: Loss and default rate data are not always properly identified, and may inadvertently misrepresent 7(a) loan program performance.

Loss Data. In addition, we found that the presentation of SBA's loss rates in the Annual Loss Studies and in some submissions to Congress needed additional clarification. The loss rates presented do not always clearly identify the figures provided. For example, it is not always clear whether only pre-credit reform (loans disbursed before 1992) or both pre- and post-credit reform data are being used, or when rates include only guaranty loans or both direct and guaranty loans. Although it is not indicated in the Annual Loss Studies, the OCFO has included only pre-credit reform loans in charge-off and recovery figures in calculating the commercial loss rate but has used both pre- and post-credit reform loan information in the average outstanding portfolio figures. Data used in the loss rate calculations should be consistent and clearly identified. If post-credit reform charge-offs and recoveries are included in the commercial loss rate calculation, the rates will increase slightly from 1.18 percent to 1.28 percent in FY 1994 and from .81 percent to 1.02 percent in FY 1995. (See Table 2 in Appendix A.) As the FY 1992 loan cohort matures, however, the effect of omitting post-credit reform loans will become stronger.

Default Rates. The terms "loss rate" and "default rate" are sometimes used interchangeably in the media and in Congressional hearings. According to program officials, the loss and default rates are often confused due to the lack of a standard definition of the term default--within either SBA or the private banking industry. In the banking industry a loan is in technical default if the borrower is in violation of some specific provision of the loan agreement--even though the borrower may be current in his/her loan payments. Usually, however, banks do not place a loan in liquidation based on a technical default. According to Federal regulators, banks do not report a default rate, so no aggregate data on industry defaults is available. Banks do, however, track and report delinquent loans, and the FDIC compiles data on past due loans and computes delinquent loan ratios.

SBA's Loan Servicing SOP defines default as a delinquency in a payment on a loan. OFA officials suggest, however, it is not entirely clear whether a default occurs when a payment on the loan is 30 days past due (and therefore no longer current), when the payment is 60 days past due, or when the loan is in liquidation. The OCFO treats SBA's purchase rate (also called the "repurchase" rate) as the default rate. Under SBA's guaranty agreement with lenders, a lender can request that SBA purchase the guaranteed portion of the outstanding loan if an installment remains unpaid for more than 60 days. The purchase rate is calculated by dividing total purchases for one year by total disbursements for the year. Because the outstanding portfolio (the denominator) has grown significantly while purchases (the numerator) have remained relatively constant, the combined pre- and post-credit reform purchase rates can be misleading. (See Table 3 in Appendix A.) Nevertheless, because purchases are the earliest indication of potential loan losses, there is a benefit to using purchase rates to monitor loan performance.

Even when the purchase rate is used as the default rate, there may still be some confusion. For example, a table labeled "Default Rates," which was submitted by SBA to a March 1995 hearing of the House Committee on Small Business, did not represent either delinquency rates or actual purchase rates, but forecasted purchase rates for annual

cohorts without labeling them as such. In short, SBA needs to make a stronger effort to clarify the meaning of the default rates it cites and to apply them in a consistent manner.

Recommendation 2: We recommend that the OCFO and OFA ensure that information on loss and default rates is more clearly defined and labeled.

Conclusion 7: While the actual and ultimate loss rates are used primarily for internal purposes, the Annual Loss Studies in which they are published contain useful program performance information.

Actual and Ultimate Loss Rates. In addition to the commercial loss rate, the OCFO also publishes actual and ultimate loss rates in the Annual Loss Studies. (See Table 4 in Appendix A for historical data.) There are no aggregate banking industry rates comparable to SBA's actual and ultimate loss rates. Moreover, these loss rates are used for internal SBA purposes.

SBA has used the actual loss rate to track losses from the inception of the 7(a) loan program. It is composed of cumulative net charge-offs divided by cumulative disbursements. Because the actual loss rate is not limited to one year of data, it is significantly higher than SBA's commercial loss rate and banking industry loss rates.

The ultimate loss rate is an estimate of total future losses on loans presently outstanding. The OCFO computes it by adding an estimate of losses on loans that have not yet been purchased (projected losses) and an estimate of losses on loans that have already been purchased (allowance for losses) to the cumulative net losses. The projected losses and allowance for losses figures are calculated using historical loan data and projections about future loan behavior. These estimates provide the basis for establishing a "reserve" for future losses on the existing pre-1992 portfolio.

It is assumed that most of the losses on loans in the pre-credit reform cohort will occur within the next ten years, and when all charge-offs and recoveries have been made, the actual and ultimate loss rates will converge. For loans approved after FY 1991, the cost of Federal credit is estimated based on the subsidy rate when the loan is disbursed, as opposed to a forecast of future losses. Thus the use of the subsidy rate to estimate loan costs will eliminate the need for an ultimate loss rate calculation.

Annual Loss Study. Although the actual and ultimate loss rates are used primarily for internal purposes, the Annual Loss Studies contain useful information on recoveries, purchases, charge-offs, as well as other data that relate to the performance of all SBA loan and investment programs. Credit reform has

significantly changed the way loan information is tracked. This has necessitated two different methods of presenting loan information in the Annual Loss Study--one for pre- and one for post-credit reform data--which has complicated the format of the study. It would be useful for the OCFO to review the organization and content of the study to determine whether revisions are needed.

Recommendation 3: We recommend that the OCFO determine, in consultation with appropriate program officials, whether revisions can be made in the format of the Annual Loss Study to clarify loan loss data.

APPENDIX A

Table A.1. Ending Year Portfolio Balance and Rate of Growth
(millions of dollars)

Year	SBA 7(a) Guaranty Loans	Change	Banking Industry C& I Loans ^a	Change
1986	9,267		600,858	
1987	9,218	-0.53%	589,675	-1.86%
1988	9,198	-0.22%	600,400	1.82%
1989	9,600	4.37%	618,625	3.04%
1990	10,295	7.24%	615,311	-0.54%
1991	11,491	11.62%	558,962	-9.16%
1992	13,067	13.72%	536,340	-4.05%
1993	15,082	15.42%	538,952	0.49%

1994	17,327	14.89%	589,120	9.31%
1995	20,279	17.04%	630,095	6.96%
^a C&I = Commercial and Industrial Loans.				
Source: U.S. SBA <u>Management Information Summary</u> , MARS 393, FY 1986-1995.				

**Table A.2. 7(a) Combined Commercial Loss Rates
(Pre- and Post-Credit Reform Loans)**

Year	Loss Rates on Pre-Credit Reform Loans	Combined Loss Rates
1992	1.97%	1.97%
1993	1.60%	1.62%
1994	1.18%	1.28%
1995	0.81%	1.02%
Source: U.S. SBA, OCFO, Annual Loss Studies. The <u>Annual Loss Study, FY 1995</u> was still in draft when this table was printed.		

Table A.3. 7(a) General Business Loans Purchase Rates

Fiscal Year	Pre-Credit Reform	Pre- and Post-Credit Reform^a
1986	20.05%	
1987	20.15%	
1988	20.12%	
1989	20.42%	
1990	19.83%	
1991	20.71%	
1992	20.60%	16.96%
1993	20.60%	16.27%
1994	20.60%	15.23%
1995	20.60%	14.73%
^a Purchases under credit reform begin in FY 1992 and have been calculated by the inspection team.		
Note: Purchase rates shown in the Loss Studies do not include post-credit reform data in either the numerator or denominator.		
Source: U.S. SBA, OCFO, Annual Loss Studies. The <u>Annual Loss Study, FY 1995</u> was still in draft when this table was printed.		

Table A.4. Actual and Ultimate Loss Rates

Year	Actual Loss Rate	Ultimate Loss Rate
1986	6.96%	12.27%
1987	7.47%	12.39%
1988	7.98%	12.52%
1989	8.25%	12.71%
1990	8.38%	12.27%
1991	8.32%	12.80%
1992	8.65%	12.68%
1993	9.14%	12.46%
1994	9.61%	12.22%
1995	9.61%	11.85%
Note: Loss Rates include 7(a) guaranty loans only.		
Source: SBA, OCFO, Annual Loss Studies. The <u>Annual Loss Study, FY 1995</u> was still in draft when this table was printed.		

APPENDIX B

GLOSSARY

Actual Loss Rate

The ratio of cumulative net losses to total cumulative disbursements.

Allowance For Losses

An estimate of future losses on loans that have already been purchased.

Charge-Offs

Synonymous with the term write-off. It is the process by which SBA recognizes a loss on its records, removes uncollectible accounts from its active receivables, and authorizes cessation of loan office collection activity.

Cohort

A group composed of loans approved in the same fiscal year. Cohorts may be further classified according to loan type and loan program. Loans approved prior to October 1, 1991, are tracked as a single cohort.

Commercial Loss Rate

The ratio of net charge-offs to the average outstanding loan balance. It is calculated annually and is designed to produce a loss rate that is comparable to those published by the private sector.

Disbursements

Cumulative total of the principal amount loaned under a particular program. Depending on the loan type, e.g., direct or guaranteed, the disbursement of monies is made by SBA or the participating lender.

Federal Credit Reform Act

Provides a measure of Federal agencies' costs for financial assistance programs. All Federal direct and guaranteed credit is required to be treated consistently across the Federal Government. This process is based on the calculation of a subsidy rate for each distinct loan program.

In Liquidation

A classification used when it is necessary to enforce collection or when the Agency's interest in collateral may be in jeopardy as a result of any type of insolvency proceedings.

Judgment

A judicial determination in court that a borrower owes SBA money.

Net Charge-Offs

Gross charge-offs less recoveries.

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Pre-Credit Reform Loans

Loans approved prior to October 1, 1991.

Projected Loss

An estimate of future losses on loans that have not yet been purchased.

Purchase Rate

The ratio of total purchases to total disbursements.

Recoverable Expenses

Expenses incurred by SBA on behalf of the borrower that are charged to the borrower's loan account, increasing the amount owed to SBA.

Subsidy Rate

An estimate of the cost of Federal credit approved since October 1, 1991. It is based on a present value analysis of expected cash flows for each credit program for each approval year (cohort). By using the subsidy rate, the cost of Federal credit is recognized at the time the decision is made to approve program levels.

Ultimate Loss Rate

An estimate of total future losses on loans presently outstanding. It is computed by adding the projected losses and the allowance for losses to cumulative net losses.

APPENDIX C

DATE: June 18, 1996

TO: Tim Cross

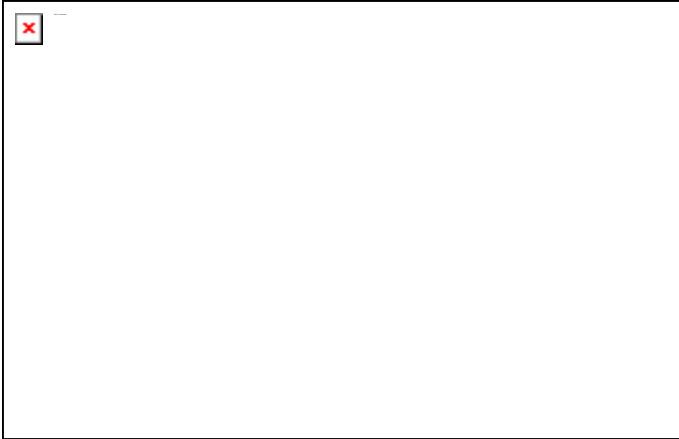
Assistant Inspector General

for Inspection and Evaluation

FROM: Director, Financial Administration Staff

SUBJECT: Comments on Final Draft Inspection Report

Enclosed are the written comments of the Office of the Chief Financial Officer on your final draft report entitled "The 7(a) General Business Loan Program Loss Rate." You may contact me on 205-6103 if you have any questions on these comments.



Enclosure:

cc: Gregory A. Walter

Recommendation 1: We recommend that SBA discontinue the use of the commercial loss rate for the 7(a) general business program.

Management Response:

The review by the Office of Inspector General (OIG) concluded that SBA's commercial loss rate for its 7(a) general business program is not comparable with banking industry loss rates. The OIG asserts this because the composition of SBA's portfolio is fundamentally different in loan size, SIC of borrowers, collateral, and operating policies, including the timing of loan charge-off, from bank loans. In addition, the OIG concluded that the usefulness of SBA's commercial loss rate is limited because of SBA's rapidly expanding portfolio and a three to four year lag between loan disbursement and charge-off. The OIG asserts that the large increase in SBA's outstanding loan guaranties since 1992 and the natural lack of early year losses serve to dramatically understate the commercial loss rate compared to the banking industry. Finally, the OIG asserts that SBA program officials use the Federal Credit Reform subsidy rate, the actual performance of "loan cohorts", portfolio currency rates and purchase rates in their management of the 7(a) guaranty program. As a result, the commercial loss rate is not useful as a management tool.

The Office of the CFO (OCFO) acknowledges the validity of the arguments made by the OIG. The commercial loss rate was included in the loss study a number of years ago, prior to Federal Credit Reform, in response to Agency management. The commercial loss rate was seen as an indicator of program cost and also as a comparison to loans made by the banking industry. It may well be that the usefulness of this measure has been eclipsed by Federal Credit reform measures.

Prior to discontinuing existing procedures to compute the commercial loss rate, the OCFO will circulate a decision document to SBA's top management officials to address this issue. The arguments made by the OIG for the 7(a) guaranty program also apply to Disaster, 504 Development Company, and SBIC programs. As a result the decision document will address the commercial loss rate as it applies to all of the SBA's lending programs. Assuming management's concurrence, the OCFO will discontinue its process to maintain information to calculate the commercial loss rate and will not provide information on this rate in the future.

Recommendation 2: We recommend that the OCFO and OFA ensure that information on loss and default rates is more clearly defined and labeled.

Management Response:

The OIG in its review found that loss and default data are not always properly identified, and may inadvertently misrepresent 7(a) loan program performance. The loss data for loans made prior to the advent of Federal Credit Reform on October 1, 1991 is presented differently than for loans made under Federal Credit Reform. In addition, the OIG found that the use of the terms "loss rate", "default rate" and "purchase rate" by federal officials and the media is inconsistent and confusing. Default rate is often used instead of the loss rate or the purchase rate. The overall result of this confusion is at times to misrepresent loss or purchase rate information.

The OCFO understands and agrees with the OIG conclusion that the technical terms involved with loans losses are sometimes misused. The cause of this confusion is probably the somewhat complex nature of SBA's loan programs. Federal Credit Reform has added to this technical complexity. The OCFO loss study is inherently by nature a

complex document that can be confusing to readers unfamiliar with the technical terms used in lending programs.

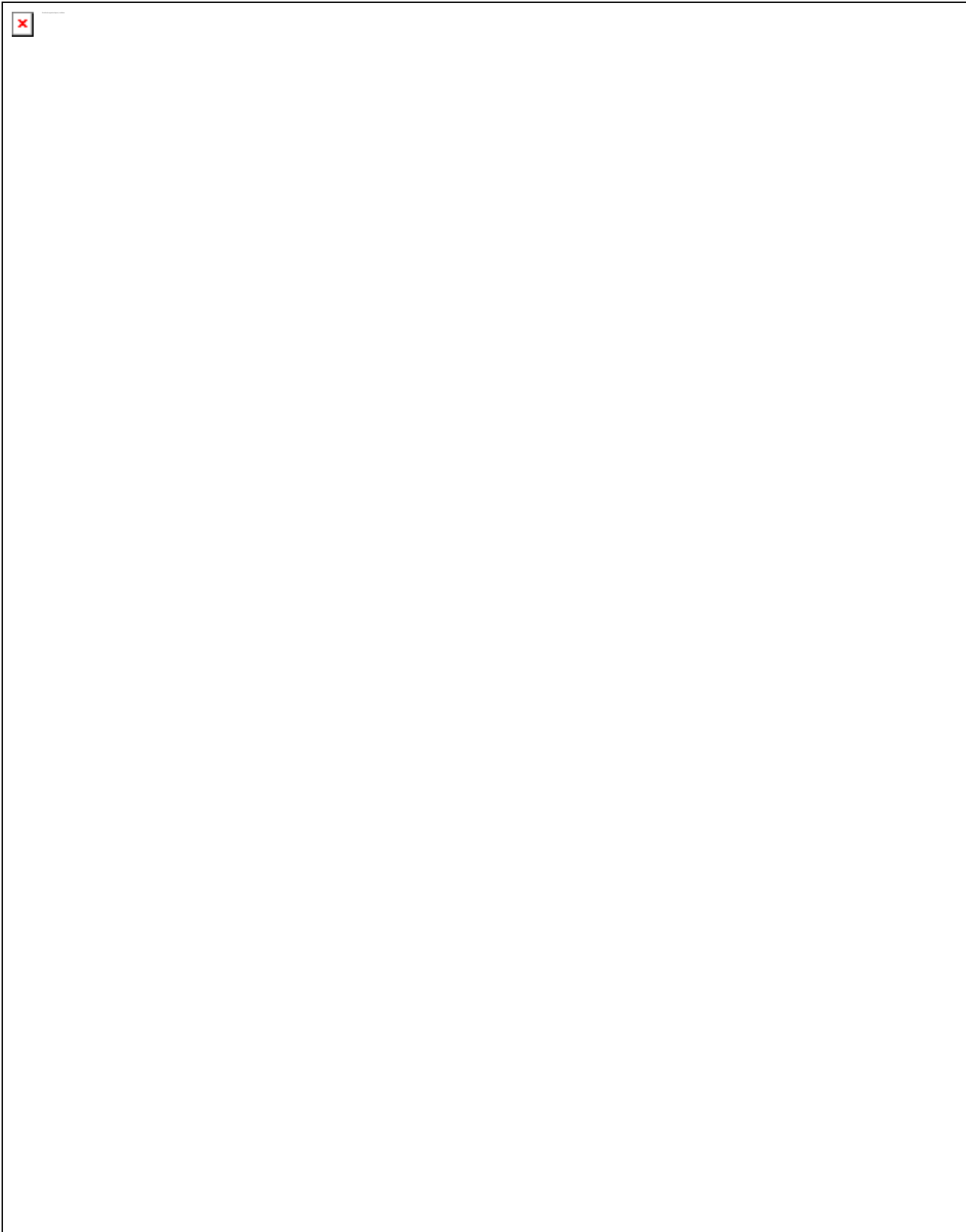
Nevertheless, the OCFO agrees that its loss study could be improved to better define and consistently label information included in the study. The FY 1996 study will be redesigned to condense and clarify the information provided. Information provided will be clearly identified and labeled for loss rates and purchase rates.

Recommendation 3: We recommend that the OCFO determine in consultation with appropriate program officials, whether revisions can be made in the format of the Annual Loss Study to clarify loan loss data.

Management Response:

The OIG noted in its study that, while the "actual" and "ultimate" loss rates are primarily used by the OCFO for internal purposes, the Annual Loss Study has program performance information useful for others inside and outside the Agency. Further, the OIG noted that the inclusion of Federal Credit Reform results using a different treatment in the loss study than for pre-Credit Reform loans has complicated the format of the study. For this reason, the OIG has recommended that the OCFO review the format of the study to determine whether revisions may be needed from the point of view of users outside the OCFO.

The Annual Loss Study should meet the needs of the Agency management and provide information internally within OCFO. The OCFO will review the format and content of its Annual Loss Study for the FY 1996 study. Initial thoughts are to condense the study to provide the actual loss rates results, without presenting the extensive amount of information that is currently presented. Additional information will be maintained in OCFO records available to interested parties upon their request. The OCFO will review the display of pre and post Federal Credit Reform information. Where feasible, the OCFO will use a constant format. Primary users of the Annual Loss Study outside the OCFO will be consulted as part of the redesign effort.



APPENDIX E

CONTRIBUTORS TO THIS REPORT

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